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PNW: Commission Falls Apart - Downgrading to SELL: SCRs Unresolved; ACC Amends Proposed ROE to Draconian 8.7%

PNW SELL

Pinnacle West Capital Corporation
Sector: Power & Utilities

Rating Change

Share Price	$74.18
Price Target	$58.00
Prior	*$97.00*

EPS ($) (FY DEC)	1Q	2Q	3Q	4Q	FY
2021	0.32	1.91	3.05E	(0.04)E	5.23E
P/E					14.2x
2022	0.27E	1.64E	3.10E	0.21E	5.23E
P/E					14.2x
2023	0.32E	1.70E	3.19E	0.29E	5.49E
P/E					13.5x

Market Data	
52-Week Range	$69.89 - $91.88
Dividend	$3.52
Dividend Yield	4.7%
Market Cap (M)	$8,366
Shares Out (M)	112.8
ADV (3 mo; 000)	855

Key Message: We are downgrading PNW two notches to SELL from BUY. This negative revision in our thesis represents a forward fundamental deterioration call, a negative earnings revision call, incremental equity/balance sheet worsening call, a call that reflects the state of AZ being the most value destructive state in the country including within our +40 utilities under coverage, and lastly, this ratings change is also a valuation call as the utilities earnings power for '22/'23, all else equal, points to a utility that has moved from a discounted name to one that is now overvalued. The Arizona Corporation Commission has now confirmed that they are the single most value destructive regulatory environment in the country as far as Investor Owned Utilities are concerned. In our view, rather than positioning itself as a steward of good public policy and a guardian of ratepayers' interests, as is often the case in other states, the ACC does not appear to take a cooperative approach to the companies it regulates, and worse, seems to misconstrue the fundamentals of utility ratemaking. We are particularly concerned about the severe and immediate risk posed to the company's earnings, cash flows, and balance sheet, which appears likely to lead to credit rating downgrades and higher near-term equity financing needs. Given the current makeup of the commission, we therefore see little hope for any sort of outside intervention and believe the status quo is likely to persist. Based on our current 2022 EPS estimate of $5.23, we apply a 40% discount vs a peer average multiple to arrive at our new PT of $58 (vs $97 previously). Theoretically, based on the implied impacts of adopting the amended ROO as it currently stands, 2022 EPS might end up closer to $3.50, which would mean the stock is currently being valued at 21.2x on yesterday's close, and therefore expensive in our view.

Overall Thoughts? We are downgrading PNW two notches to SELL from BUY not due to any actions by management or perceived issues with the company itself (CEO Jeff Guldner presented very strong arguments during the hearings as did Staff who remained in support of PNW as we think about key facets of the rate setting items), but instead based on our view that the **Arizona Corporation Commission is now confirmed to be the single most value destructive regulatory environment in the country as far as Investor Owned Utilities are concerned.** Rather than positioning itself as a steward of good public policy and a guardian of ratepayers' interests, as is often the case in other states, **the ACC does not appear to take a cooperative approach to the companies it regulates, and worse, seems to misconstrue the fundamentals of utility ratemaking as we saw over the 3 days of monitoring the public GRC hearings.** Of particular concern, is the disconnect in commissioners' minds between penalizing APS's earnings and cash flows, and the resulting direct impact of higher ratepayer bills due to lenders charging the utility more to borrow the same amount of money because of the higher perceived level of risk vs investing in utilities not regulated by the commissioners of the ACC. **We highlight the irony of a commission which aspires to protect ratepayers ultimately harming them due to a misunderstanding of ratemaking matters.** Investors should recall that unlike in the 37 states where commissioners are appointed, often directly because of their knowledge and experience related utility operations and regulation, Arizona has elected commissioners. Importantly, commissioners of the ACC function in an Executive capacity, adopt rules and regulations in a Legislative capacity, and also act in a Judicial capacity sitting as a tribunal and making decisions on contested matters. **All of this is done without direct oversight by either the governor or the legislature due to the ACC's role as defined in the state's constitution.** Given the current makeup of the commission and the data points that unfolded on the 3rd day of hearing which concluded last night, we therefore see little hope for any sort of outside intervention and believe the status quo is likely to persist. Our PT moves to $58 from $97.

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ACC - Docket Control - Received 10/7/2021 9:54 AM
ACC - Docket Control - Docketed 10/7/2021 10:00 AM

What happened? Over the past three days, the Arizona Corporation Commission has held a series of Special Open Meetings to hear comments from the public and intervenors, to question management directly, and to vote on many proposed amendments to the ALJ's ROO for the rate case. **The commission has voted to adopt amendments which would cause an already overly punitive ROO to become draconian, in our view. Specifically, lowering APS' proposed authorized ROE to 8.7% (a further $34.5m reduction in base rates vs the ROO's proposed $111.4m reduction at a 9.16% ROE), and once again pushing out making a decision on the SCRs in favor of continuing to investigate and deliberate whether to allow some or all of the SCRs into rates.** <u>Although a final vote has not yet taken place and so the potential remains for these terms to change, after watching three solid days of commission meetings (which concluded late last night) and hearing the commissioners' respective thought process and reasoning in deciding to vote how they each have so far, we are skeptical of the likelihood of the amended ROO being materially revised in favor of the utility at this point.</u>

Why downgrade now? We had held out hope that reason would prevail at the Arizona Corporation Commission, namely that commissioners who pride themselves on protecting the best interests of ratepayers would come to understand how their actions will drive up ratepayer bills while simultaneously limiting the amount of progress the state is able to make in its clean energy transition plans. **We have been disappointed to see that the ACC does not seem to understand that weakening Arizona Public Service's financial metrics, <u>regardless of the rationale for doing so</u>, is bound to ultimately drive up ratepayer bills despite offering no corresponding improvement in service to show for the higher costs.**

What's next? The Hearing Division and Arizona Public Service will separately file their projections of the revised revenue requirement should the ROO be adopted along with the proposed amendments which were each passed after obtaining at least a 3 to 2 majority vote in favor by the sitting commissioners. **We expect to see these separate filings in the next week or two (and will be available HERE once posted), ahead of the ACC's next scheduled Open Meeting taking place on Oct 26th—27th (live webcast will be HERE).** It is our hope that ahead of that meeting, the ratings agencies will be able to review the credit impacts to APS of the revised revenue requirement as currently proposed, and perhaps provide the commission with some context on how much APS' borrowing costs could increase by, and **therefore how much ratepayers' bills would then increase by for years to come, by the ACC's own hand.**

Earnings power/Pro forma valuation: With the SCRs punted to a later proceeding which continues a key overhang on the shares, $73m of APS' original $169m revenue requirement increase has been effectively removed. This was already factored in to the ROO's $3.6m revenue requirement increase and $111.4m base rate decrease as originally proposed. However, the 8.7% RUCO ROE from Olson amendment #1 and which was adopted 4-to-1, represents an incremental $34.5m decrease to base rates on top of the ROO's $111.4m base rate decrease as proposed. We estimate that this could further reduce EPS by ~$0.18/sh. without even factoring how the SCR recovery will pan out.

We maintain our current 2022/2023 estimates of $5.23/$5.49 as we await the company and ALJ's filings detailing the financial impacts and change in revenue requirement from all of the adopted amendments to the ROO. **To give investors a sense of magnitude and directionality however, our high level math, which is not intended as an official forecast and will change as more details come out, would theoretically imply closer to $3.50 in 2022 and holding all else equal (i.e., ignoring future rate cases, capex changes, etc.), $3.76 in 2023, implying that the stock is trading at 2022/2023 multiples of 21.2x/19.7x, a ~6% premium vs mid/large cap peers on 2023.**

So where could shares settle? A material discount to the group is warranted, as PNW's APS utility was already going to have to face the same commission in ~6-7 months from now for another rate case, and may now have to file an emergency rate request shortly after the final vote in the current case as a result of the commissioners' amendments to the ROO. The unfortunate backdrop is that Arizona is distinguishing itself as a state where investors not only need to accept among the lowest returns in the country but must also be concerned about recovery of their capital given the commission's aggressive approach to prudency and disallowances. Simply put, we ask the question: why should anyone choose to invest their money in maintaining and developing Phoenix's electric grid when nearly every other investor-owned utility in the country offers better returns and less risk of outright loss from after-the-fact disallowances?

Valuation: We arrive at our PT of $58 for PNW using a heavily discounted 2022 regulated group average P/E multiple of ~11x given recent value destructive events we discussed above, to our current 2022 EPS estimate of $5.23. **We acknowledge that our estimates and those of others on the Street may change significantly when the company releases its revised revenue requirement to reflect all of the amendments to the ROO in the coming days,** but above, we do provide investors with a line of sight on directionality and magnitude of the potential earnings impact to the company based on last night's commission votes, *all else equal*.

VALUATION & RISKS

PNW - SELL - $58.00

VALUATION

We arrive at our PT of $58 for PNW using our 2022 base regulated group average P/E multiple of 18.5x and apply a ~7.5x discount, resulting in a consolidated multiple of 11x P/E, applied to our 2022 EPS estimate of $5.23. Our ~7.5x discount reflects: (1) an implied ~5.5x discount for a steep potential deterioration in earnings (~5.5x discount representing a potential drop in earnings power to ~$3.50 per share) resulting from the amended ROO as proposed (pending regulatory outcome) and (2) the broader deterioration of the regulatory construct in AZ representing a 2.0x discount to the peer regulated group (in our view, now the least attractive jurisdiction from an investment standpoint).

We note: PNW should see both decreasing EPS estimates as well as a potentially steepening discount of its multiples relative to peer utilities as the company confirms the impact which the amended ROO as proposed would have on its revenue requirement, earnings, and cash flows, if it is adopted. We anticipate a further deterioration of EPS estimates and a steeper discount versus peers should the amended ROO actually be adopted in its present form after the commission is made aware of the harm doing so would cause not only to shareholders, but to ratepayers through higher borrowing costs for years to come. It is also important to note that the worse the result, the more likely the company is to need to file another rate case in the months ahead, which would once again stress the regulatory construct and present further revenue/earnings uncertainty.

RISKS

Upside risks primarily consist of a better than expected final decision from the Arizona Corporation Commission in the rate case and/or a change in the makeup of the ACC Commissioners whereby a majority of the state's utility regulators are comprised of pro-business commissioners with a more thorough knowledge of fundamental utility ratemaking.

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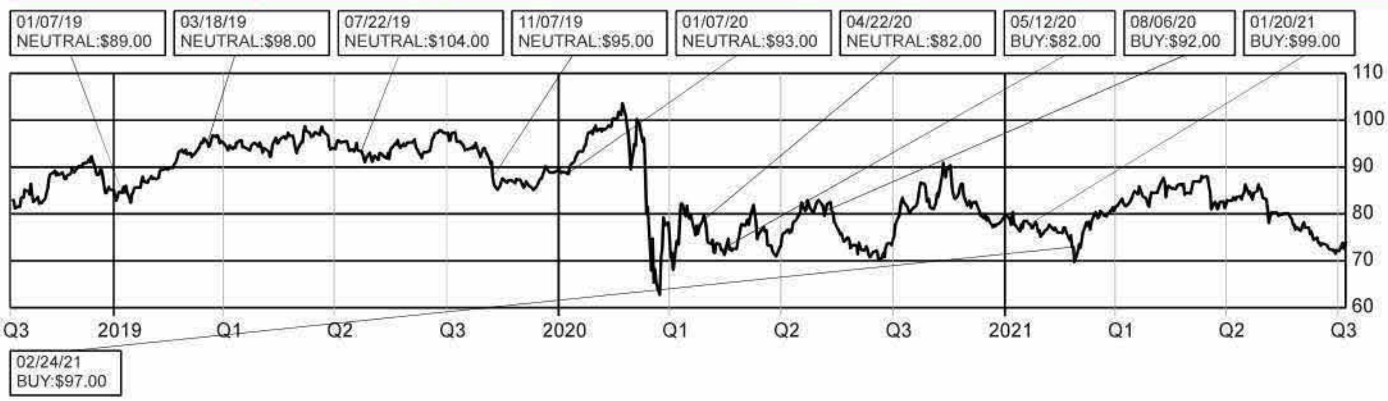
Rating and Price Target History for: Pinnacle West Capital Corporation (PNW) as of 10-06-2021



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